

PERAC Financial Bulletin

NO. 17, APRIL 2003

WATCHING AND WAITING

For most of the first quarter, the uncertainties of war weighed heavily on an economy that was already very fragile. The big question was whether the recent weakness in the economy and the stock market largely reflected a temporary, war-related problem or a continuation of the troubles left over from the excesses of the late 1990s. Would a successful conclusion to the war in Iraq bring a resumption of corporate capital investment and a new spark to consumer spending? As US forces entered Baghdad during the second week in April, the market surged on hopes that investors would not have to wait much longer for these and other fundamental questions to be answered.

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FINANCIAL MARKET REVIEW

First Quarter, 2003

The new year began on a hopeful and positive tone, as investors were encouraged that the worst of the three-year bear market might finally be behind us. By mid-January, however, the market began to fixate on the increasingly likely prospects of war and, despite a rally that ensued once the war actually commenced in late March, most of the major stock indices ended the quarter in negative territory.

The market had sunk back close to the lows of 2002 under the weight of the uncertainties of war, but when the beginning of hostilities was actually signaled, stocks enjoyed one of their strongest rallies in years, up as much as 13% in some major indices. As the perception took hold that the war would be neither quick nor easy, market sentiment changed. About half the rally's gains were dissipated by month end.

The war brought further distress to an economy that was already fragile, but once the bombing and shooting began, the market's focus was detached from the domestic business picture. Indeed, one didn't have to watch one of the news channels to discern

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the latest developments in the war. One could accurately gauge the progress on the battlefield by simply observing the rising and falling of the market indices. For the most part, stocks traded up and down in greater unison than normal, as little attention was being paid to the characteristics of individual stocks.

Surprisingly, the NASDAQ Composite was the only one of the broad indices to avoid a negative return for the quarter. Many observers felt that the index's performance was based more on hope than reality since corporate demand for information technology was still dormant. The S&P 500 large cap index was off 3.6% while the broad market Wilshire 5000 declined 3.1%.

Besides the relative strength of the technology-laden NASDAQ, there were other indications that some of the major trends of the past three years had run their course. In reversals of recent patterns, large caps outperformed small caps and growth outperformed value. (See Table.)

Considering sectors, consumer stocks joined technology among the best performing areas. Airlines, an industry whose bleak prospects have been dealt a further blow by the onset of

Chart 1 | Past 12 Months: The Bear Market Continues

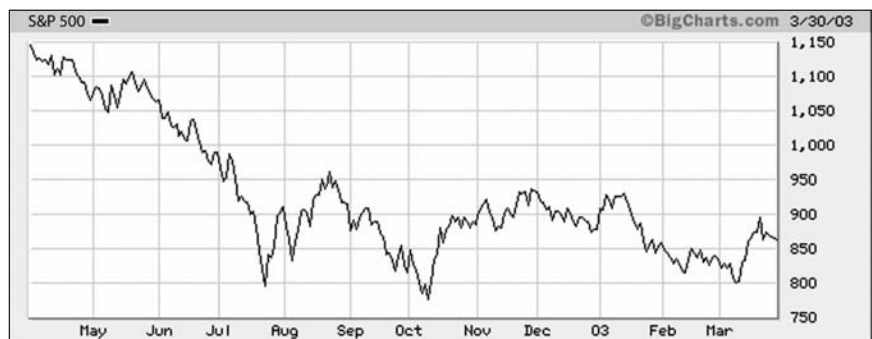


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war, were among the worst. Somewhat surprisingly, defense stocks were indifferent performers, as were energy companies despite the fact that oil prices remained high.

In another disappointing quarter for proponents of global diversification, interna-

tional stocks failed to provide a meaningful buffer against losses in the US market. Indeed, despite a weak dollar, which would tend to improve returns from overseas holdings, the MSCI-EAFE underperformed all major domestic indices, indicating that the

world economy is unable to sustain an economic recovery without a boost from the US.

Other Markets

Despite the fact that interest rates began the year at historic lows, they remained relatively stable during the quarter, as the 10-year Treasury note remained around its 40-year low of 3.8% while the 2-year note's rate of 1.5% was the lowest in nearly 60 years. With the fear of war, and ultimately the reality of war, keeping a lid on consumer sentiment and economic growth, and with investors still focusing on bonds as a more stable alternative than volatile stocks, there was little upward pressure on interest rates. As the yield spreads between high and low quality credits narrowed somewhat from previously wide levels, corporate bonds generally did slightly better than Treasuries. With default rates beginning to fall and investors taking advantage of their very attractive yield differentials versus high grade bonds, high yield "junk" bonds were the best performing segment of the fixed income market.

In alternative investments, venture capital remained mired in very difficult circumstances. The process of marking down portfolio company

Chart 2 | From the Top: The 3 Year Decline of the S&P 500 and NASDAQ



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Chart 3 | S&P 500 vs NASDAQ: Before and After the Bubble

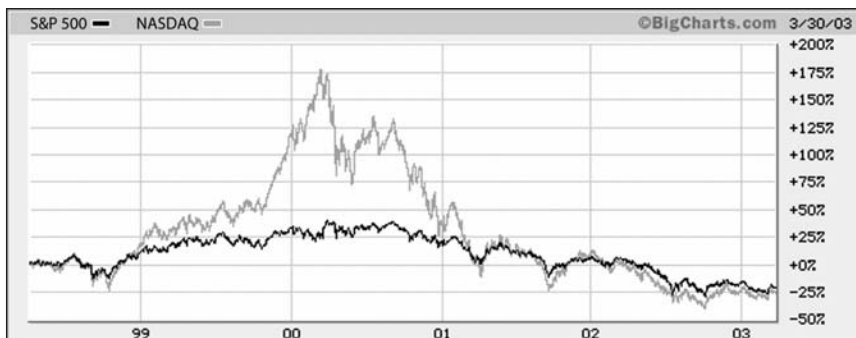


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Chart 4 | S&P 500: A Ten-Year Perspective

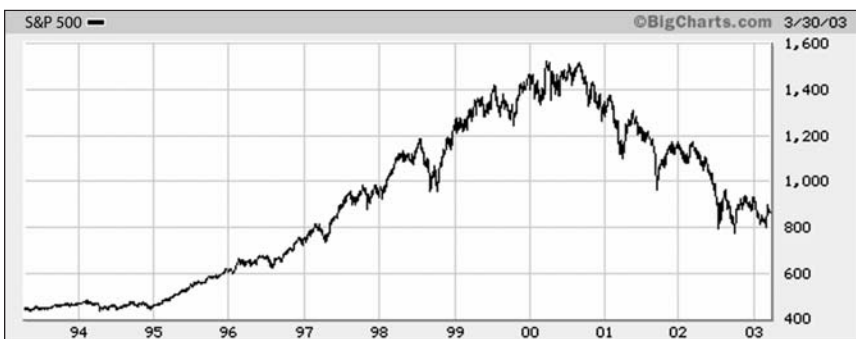


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Sharply lower funding levels are bringing financial distress to private and public pension funds nationwide.

holdings to more realistic levels continued, as demand for new technology products remained weak and the window for Initial Public Offerings remained essentially closed. Only four IPOs came to market during the quarter, the worst performance since the fourth quarter of 1990. New investing continued to slow down to a trickle as available funds were used largely to nurture those companies deemed most likely to survive. The latest available data show that returns from venture capital were - 22.3%, according to Venture Economics, and - 29.4%, according to Cambridge Associates, for the twelve months ending September 30, 2002. Corresponding returns from private equity overall were -12.3% and - 9.2%, respectively.

As it has for the past three years, real estate continued to offer diversification benefits relative to the volatility of the equity market. Nevertheless, the sector has clearly begun to reflect the effects of national economic weakness. After declining to the low single digits in 2002, returns on REITs were essentially flat during the first quarter. Returns on privately-held real estate, which are usually slow in reflecting actual market trends due to lags in valuation, indicate returns that remain positive but significantly lower than those of the recent past. To date, there is no one sector—apartments, industrial, office, or retail—or region of the country that is being impacted significantly more than another. While some analysts see real estate prices as vulnerable to further economic weakness, the fact that supply and demand have been in reasonable balance in most markets weighs against a major collapse.

The hedge fund industry consists of many different strategies, ranging from conservative to speculative, and there is no single universe that tracks the performance of all existing funds. Nevertheless, the most widely followed hedge fund databases indicate that these funds, in aggregate, continue to offer reasonable

diversification against the declining equity market, although reported returns are only very modestly positive. While hedge funds continue to draw increasing interest from public pension funds, these unregulated funds are also attracting increased scrutiny from governmental authorities. Both the National Association of Securities Dealers (NASD) and the Securities and Exchange Commission (SEC) will be conducting hearings this spring on the investing practices of hedge funds and whether the risks inherent in these funds are being adequately disclosed to potential investors.

Outlook

The bear market of the past three years has brought the subject of pension funding to the front pages of the financial media as sharply lower funding levels are bringing financial distress to private and public pension funds nationwide. Other than to maintain well-diversified portfolios overseen by a roster of capable investment managers, there are no easy solutions to avoiding losses during periods such as these.

Looking forward, a number of recent statistics— from further job losses to lagging auto sales to stagnant industri-

Chart 5 | Corporate Earnings Have Fallen Dramatically

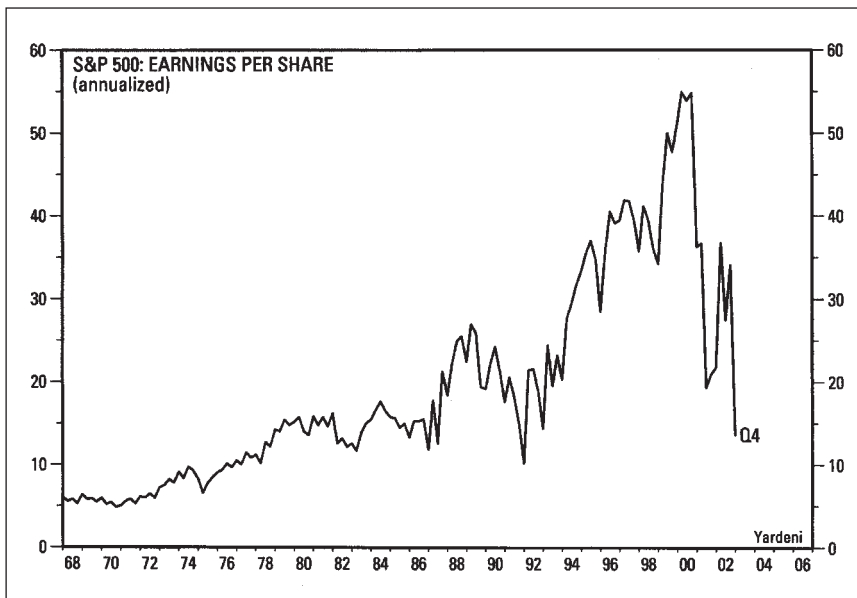


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Chart 6 | Price/Earnings Ratios: Lower But Not Low

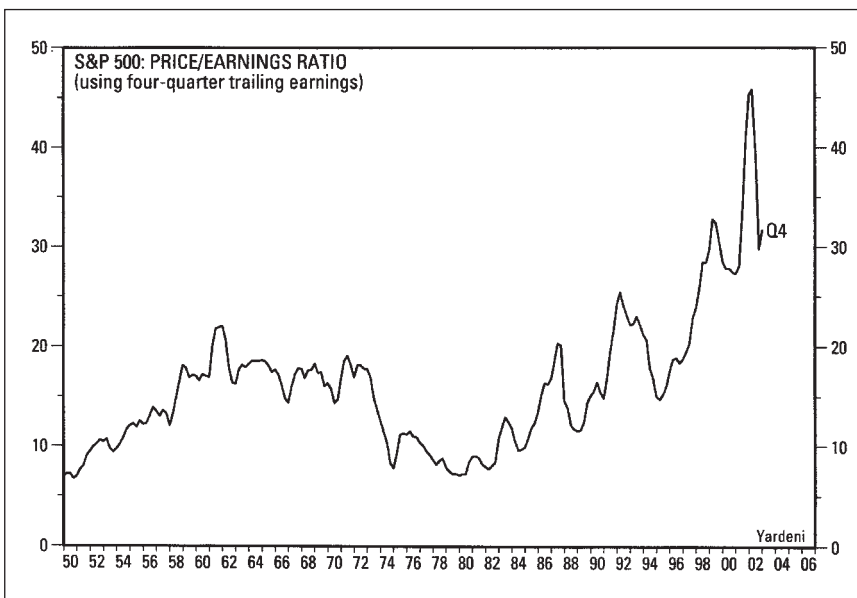


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al production—indicate an economy that was far from robust as the second quarter began. Sanguine economists hope that a rapid and favorable resolution of the war would bring a new spurt of economic vitality. Others

worry that continued uncertainty could tip the economy back into recession and there is concern that, with interest rates already so low, the Federal Reserve has few tools at its disposal by which to stimulate the economy

and avoid a possible decline into a dangerous period of disinflation.

In recent months, some consultants and market strategists have called for lowering the expected returns from major asset classes over the coming years. They use classic stock dividend discount models and also point to the fact that some of the components of the long-term 10% historic annualized return from stocks—such as the significant rise in price-earnings ratios over the years and dividend yields much higher than today's—are not likely to be repeated. There is certainly historic precedent for stocks to drift without direction for up to 15 years. Also, with interest rates at historic lows today, expected returns from bonds are diminished. Such arguments are compelling but they are not universally shared. Others see stocks, after a major three-year correction, poised to respond handsomely to an economic recovery. They point out that price earnings ratios have declined to fair if not historically cheap levels and that, according to historic patterns, stocks appear substantially undervalued in the context of today's low interest rates.

In the late 1990s, investors enjoyed sumptuous but unsustainable returns and

now we are experiencing the painful but inevitable correction. It is important to keep this history in mind when reviewing actuarial investment assumptions. Return assumptions are appropriately intended for long-term (i.e., 25-years or longer) horizons rather than short-term validity. PERAC's forthcoming *2002 Annual Report* will indicate that the average annual return for Massachusetts 106 public retirement systems over the past eighteen years (1985-2002) exceeds that of the Commonwealth's legislated 8.25% expected return on its pension assets. On the other hand, there is no certainty that future returns, even over extended periods, will be consistent with those of the past.

The debate over expected future returns will rage on, but there is one thing we can say with certainty: After the tumultuous and historic volatility—both up and down—over the past several years, a return to a period of normalcy cannot come too soon for investors.

As always, we welcome your comments on this report and encourage your suggestions for future investment research reports. For those systems that would like to discuss their portfolios and strategies in the

Chart 7 | Interest Rates: How Low Can They Go?

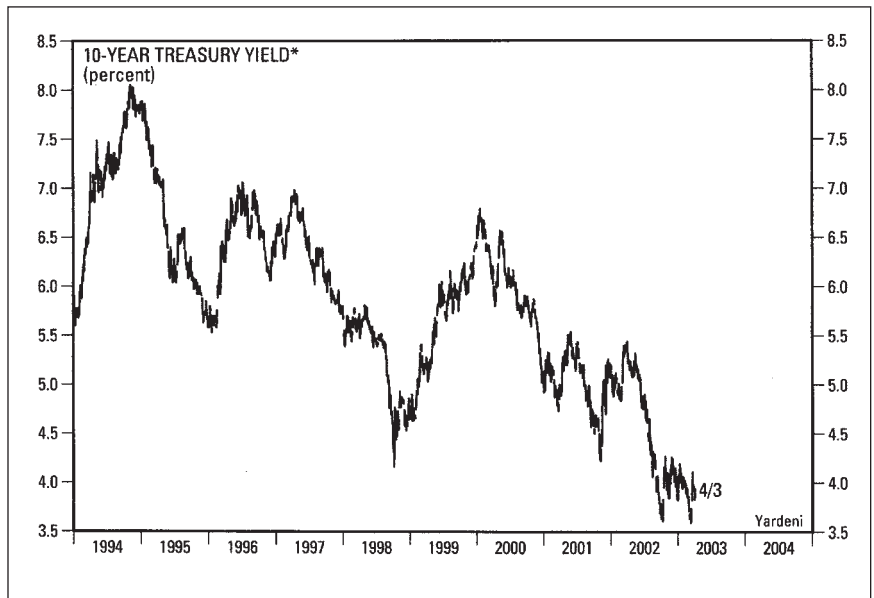


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Chart 8 | Steep Yield Curve: Precursor of a Stronger Economy?

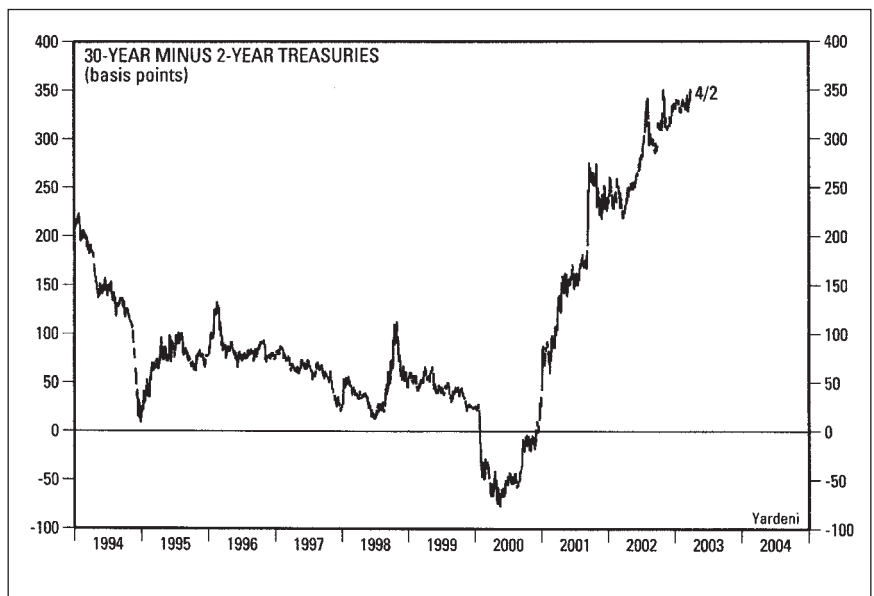


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context of the current market or to talk about any other relevant investment topics, we would welcome an invitation to attend one of your board meetings.

TOTAL RETURNS | *First Quarter, 2003*

INDEX	FIRST QUARTER, 2003	PAST 12 MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 3.64%	- 21.45%
Standard & Poor's 500 (Large Cap)	- 3.15%	- 24.76%
NASDAQ Composite	+ 0.42%	- 27.30%
Wilshire 5000 (Broad Market)	- 3.09%	- 24.03%
Standard & Poor's Mid-Cap 400	- 4.44%	- 23.45%
Russell 2000 (Small Cap.)	- 4.49%	- 26.96%
GROWTH VS. VALUE		
S&P 500 Growth	- 0.83%	- 23.61%
S&P 500 Value	- 5.51%	- 26.19%
S&P Midcap 400 Growth	- 3.02%	- 24.23%
S&P Midcap 400 Value	- 5.81%	- 22.97%
Russell 2000 Growth	- 3.88%	- 31.63%
Russell 2000 Value	- 5.08%	- 23.27%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 8.21%	- 23.07%
M.S.C.I. - Emerging Markets	- 6.00%	- 20.69%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 1.39%	+ 11.69%
Merrill Lynch High Yield Index	+ 6.90%	+ 3.65%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 0.68%	- 3.45%
NCREIF Property Index	+ 1.67% (Q4)	+ 6.74% (Trailing)